In the Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-1523

HEMPT BROS., INC., PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

The sole question raised by the petition is whether the court of appeals correctly determined that the amounts collected by petitioner on receivables transferred to it by a predecessor partnership were taxable to it and not to the partnership.

Petitioner was organized to take over a business that had been conducted in partnership form for 15 years. The business consisted principally of road and related construction, and of the quarrying, manufacture, and sale of road and related construction materials. The partnership had maintained its books and records, and filed its partnership informational returns on the calendar year basis and on the cash receipts and disbursements method of accounting. Accordingly, it did not take uncollected receivables into income, and de-

ducted the costs of materials only as they were incurred (Pet. App. 40-41).

On March 1, 1957, the partnership business and most of its assets were transferred to petitioner in exchange for which petitioner issued 12,000 shares of its stock (constituting 100 percent of its outstanding stock) to the four members of the partnership. Thereafter, petitioner carried on the business formerly conducted by the partnership. It was stipulated that the transfer was made pursuant to Section 351(a) of the Internal Revenue Code of 1954, which provides that no gain or loss shall be recognized if property is transferred to a corporation solely in exchange for stock if the transferors own at least 80 percent of the stock of the corporation.

Petitioner maintained its books and records, and filed its income tax returns on the cash receipts and disbursements method of accounting, on a taxable year basis ending February 28. In 1964, however, petitioner agreed to change to an accrual system in accordance with a requirement of the Commissioner of Internal Revenue (Pet. App. 41-42).

Among the partnership assets transferred to petitioner for petitioner's stock were accounts receivable of $662,-824.40, arising from performance of construction contracts, sales of construction materials, and rental of equipment by the partnership. In its taxable years ending in 1958, 1959, and 1960, petitioner collected the amount of these receivables, and included the amounts collected in its gross income for the year of collection. Petitioner thereafter commenced this refund suit for the taxes on the accounts receivable on the theory that such taxes were properly payable by the members of the predecessor partnership.

The decision of the court of appeals requiring petitioner to include the proceeds of the transferred receivables in its gross income is firmly supported by the legislative history of Section 351 and related statutory provisions, as well as the judicial decisions thereunder.

Since its original enactment as Section 202(c)(3) of the Revenue Act of 1921, 42 Stat. 230, Section 351(a) of the 1954 Code has permitted the change of partnerships or sole proprietorships into corporate form without the immediate recognition of taxable gain or loss. See *Helvering* v. *Cement Investors*, 316 U.S. 527, 533-534. But recognition of such gain is not eliminated; it is only deferred. Hence, pursuant to Section 358, transferors of a controlled corporation have the same basis in the stock received as they had in the transferred assets. Section 362 in turn provides that the corporation's basis in the assets received is the same as their basis in the hands of the transferors.

As a result of the operation of these provisions, petitioner held the receivables transferred to it with the same basis that they had had in the hands of the transferor partnership. When collected, the proceeds of the receivables constituted gross income to petitioner. *P.A. Birren & Son, Inc.* v. *Commissioner*, 116 F.2d 718 (C.A. 7), cited with approval by this Court in *Helvering* v. *Cement Investors, supra,* 316 U.S. at 534; *Orange Securities Corp.* v. *Commissioner*, 131 F.2d 662 (C.A. 5). It is thus that "the transferee steps into the shoes of the transferor so far as the tax basis for the property is concerned." *Portland Oil Co.* v. *Commissioner*, 109 F.2d 479, 486 (C.A. 1), certiorari denied, 310 U.S. 650.

Petitioner does not allege a conflict with this settled line of decisions. Rather, it seeks to avoid this

fundamental aspect of corporate organization and taxation by invoking the series of decisions of this Court dealing with deflected income, beginning with *Lucas* v. *Earl*, 281 U.S. 111, and extending through *United States* v. *Basye*, 410 U.S. 441 (Pet. 8). But those cases dealt with gratuitous assignments of income, where the earner of the income would have completely escaped taxation had the gratuitous assignment served to shift tax responsibility. Here, the transfer of the receivables was not gratuitous but was in exchange for petitioner's stock. Nothing in *Commissioner* v. *P.G. Lake, Inc.*, 356 U.S. 260, relied upon by petitioner (Pet. 9-10), is to the contrary. As the court of appeals correctly recognized (Pet. App. 47-48), the question there was whether the proceeds of sale of taxpayer's claim should be taxed as ordinary income or as capital gain. Section 351 was not at issue.

Here, the predecessor partnership received petitioner's stock for the assets, including the receivables that it transferred, and it holds that stock with the basis that it had in the assets transferred. Recognition of gain has been deferred, but it is potentially present in the hands of the partners. It will be recognized and taxed when the stock is sold. Indeed, to tax the proceeds of such commonly transferred receivables to the predecessor partnership, although they were collected by and available only to the corporation, would burden the incorporation of previously existing businesses in a manner contrary to the well understood operation of Section 351.

For the reasons stated, it is respectfully submitted that the petition for a writ of certiorari should be denied.

ROBERT H. BORK,
Solicitor General.

JUNE 1974.